Position Paper

CEA's submission to Hearing on the deductibility of reinsurance premiums paid to affiliates

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Summary

The CEA, the European insurance and reinsurance federation, based in Brussels, represents all types of insurance and reinsurance undertakings, including pan-European companies, monoliners and mutuals, through its 33 members, the national insurance associations.

The CEA would like to draw your attention to the negative effects of the proposals on disallowing tax deduction of certain reinsurance premiums paid to affiliated foreign reinsurers as outlined in the US Administration's 2011 Budget Proposal and in bill H.R. 3424 introduced in the House of Representatives on 30 July 2009 by Representative Richard Neal (the Proposals). The Proposals should not be upheld and consequently not progress for the following reasons:

- The Proposals would result in significant negative effects for US citizens due to:
  - More expensive insurance premiums
  - Reduced capacity for disaster cover
- The Proposals would lead to a violation of US double tax treaties and sovereignty rights of other jurisdictions.
- EU reinsurers already pay substantial taxes (the average EU tax burden amounts to approximately 25%). There is therefore no tax incentive for US affiliates of European (re)insurers to cede risks to Europe.
- The transfer pricing rules already empower the IRS to make the adjustments necessary to prevent tax evasion.
- The Proposals — only applicable to foreign (re)insurers, not to US reinsurers — would constitute a breach of the US G20 and WTO commitments.

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Expected consequences of the proposals

The Proposals impose a punitive, discriminatory double "tax" on the US insurance activities of foreign insurance and reinsurance groups, as they would only apply to affiliated reinsurance with *foreign* reinsurers. If enacted, the Proposals would damage these US businesses and increase the cost of insurance coverage for American consumers and businesses in a severe recessionary environment.

1. Negative effects for US citizens

Foreign and foreign-controlled (re)insurers play an important role in the US market. Foreign controlled insurers and reinsurers with almost 500 US-based subsidiaries provide 15% of the direct insurance and more than 50% of the reinsurance accepted in the US[i]. To serve millions of US customers, European (re)insurers have operations in many US states, collectively employing tens of thousands of US citizens.

In order to understand the harm the proposal mentioned above would cause, it is important to underline that affiliated reinsurance is used to diversify risks, an essential and basic principle in the insurance business model. Transferring variable and uncorrelated risks to a central place, as done via affiliated reinsurance, is necessary to maximise diversification benefits and smooth expected losses. Affiliated reinsurance thus plays an important part in increasing insurance capacity, in particular for low frequency, high exposure risks such as hurricane, earthquake and terrorism.

Disallowing deduction of the cost of affiliated *foreign* reinsurance would lead to double taxation for European (re)insurers active in the US that would significantly increase their costs. As a result, the efficient functioning of the US (re)insurance market would be distorted and lead to reduced capacity and competitiveness in the US insurance market. Ultimately it would result in significant negative effects for US citizens due to:

- More expensive insurance premiums: A substantial part of US demand for insurance, 15% of direct insurance and more than 50% of the reinsurance accepted in 2007, is provided by foreign-controlled insurers. For certain states and areas this figure is much higher, eg, over 90% of reinsurance for Florida property insurance is provided by reinsurance companies located in foreign countries[ii].

  If foreign insurers are not allowed to reinsure with their affiliates, the available capacity in the reinsurance market will decrease and prices for reinsurance will increase. As a result, the insurance premium prices paid by US consumers will be substantially higher. Estimations based on bill H.R. 3424[iii] show that insurance prices could increase by as much as 16% in some lines of business, costing consumers billions per year and placing a particular burden on disaster-prone states.

- Reduced capacity for disaster cover: European insurers provide a vital share of US catastrophe (re)insurance. Two thirds of the reinsurance for protection of US homes and businesses against hurricane and earthquake is provided by non-US reinsurers. Foreign (re)insurers paid more than 60% of the claims after the 2005 hurricanes (Katrina, Rita and Wilma) and the 11 September tragedy. Claims payments made by foreign reinsurers under contracts of reinsurance are taxable income in the hands of US cedants including affiliated US cedants (a point scarcely raised in the Joint Committee On Taxation paper which stands in stark contrast to "earnings stripping" transactions as detailed in the Joint Committee on Taxation paper). On this note, the Reinsurance Association of America (RAA) data on offshore reinsurance in the US market for 2008 shows that the total US premium ceded to non-US reinsurers was $58.2 billion, whilst net recoverables amounted to $121.2 billion. That is, foreign reinsurance paid nearly twice the amount in claims settlements to US cedants that it received by way of premiums received from US cedants during the same period.The introduction of the proposed discriminatory tax would prevent companies from making efficient use of capital by penalising the centralisation of uncorrelated risks in an arbitrary manner. The result would be that the availability of these insurance covers would decrease drastically and, if available, they would be much more expensive for US citizens and businesses. Previous estimations show that the supply of reinsurance would decrease drastically.

2. Violation of US Double Tax Treaties and sovereignty rights of other jurisdictions considering the following issues:

2.1 Double taxation

The Proposals would limit the deductibility of net insurance premiums paid to non-US affiliates and would lead to double taxation, given their inclusion in taxable income in both the US and the reinsurer's country of residence. Even if claims payments are made later on, these payments are treated as income in the US – notwithstanding the fact that the reinsurance premium has never been tax deductible. This is a mismatch and a clear inequity in the Proposals.

2.2 Non-discrimination

The Proposals deviate from the non-discrimination principle in the US Double Tax Treaties and are therefore inconsistent with decades of US tax and trade policy (see section 5 below). In particular, the Proposals violate treaty rules designed to prevent discrimination against foreign-owned companies. Under the Proposals, the US insurance affiliate of a European company would lose the deduction for affiliate reinsurance. This denial would violate the non-discrimination provision of the prevailing Double Tax Treaty. As an example, the Proposals violate Art. 24 Sec. 3 of the Double Tax Treaty between the US and Germany that provides that "disbursements" paid by an enterprise of one treaty country to a resident of the other treaty partner "shall, for purposes of determining the taxable profits of such enterprise, be deductible under the same *conditions as if they had been paid to a resident of the first-mentioned State."*

It also violates the provisions of the Double Tax Treaties signed by the US with several European countries, such as Germany, France, Switzerland, Italy, Ireland and the UK, based on Art. 24, Sec. 5 of the OECD Model Convention, stating that *"Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith that is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected."*

The Proposals would not only penalise foreign-owned insurers for reinsuring with affiliates, but would also allow their US based competitors to reinsure with the same jurisdictions without penalty. It therefore creates inconsistent and unfavourable treatment for foreign-owned companies, while permitting US-owned companies to take advantage of placing reinsurance with a foreign tax jurisdiction. Whereas European reinsurers and their US-affiliated insurers would therefore suffer from the denial of reinsurance premiums, their US competitors would be able to take the deduction – not only a clear violation of the Double Tax Treaties, but also further proof of the violation of a level playing field in the US insurance market. Ultimately, affected countries may retaliate with tax laws penalising US companies doing business abroad.

2.3 Election to be taxed as an insurance branch without treaty benefits

In an attempt to weaken a violation of the non-discrimination principle, the Proposals provide an election for non-US reinsurers to incur US taxation on reinsurance income from US affiliates. If elected, reinsurance income could be taxed under branch tax rules as effectively connected with the conduct of a US trade or business. The result would be modified by rules for insurance branches that require taxation of net investment income using a formula approach. The tax election would require the non-US reinsurer to waive any US tax treaty benefits with respect to the taxation of US affiliated reinsurance income.

Apart from the concerns about treaty violation discussed above, the election does not fairly tax a non-US insurer. The election would capture potentially more tax on the reinsurance income. Furthermore, the entire affiliated non-taxed premium, not just the non-deductible portion, paid to the non-US reinsurer would be treated as taxable income. Finally, the waiver of treaty benefits could subject the branch to a 30% withholding tax on actual or deemed remittances of remaining branch profits that otherwise would be eligible for a lower withholding tax rate under an applicable treaty. Consequently, up to a 55% US tax could apply to US affiliated reinsurance income.

2.4 Violation of US double tax treaties – business income

Primarily, the US tax election provision reveals the sponsor's very real concerns about the Proposals' violation of the non-discrimination principle. However, it is equally clear that the addition of this provision would not avoid tax treaty challenges.

- This provision ignores Art. 7 OECD Model Convention, which is of central importance regarding the avoidance of double taxation in the international taxation of business profits. Art. 7 states the principle that an enterprise of one State shall not be taxed in another State unless it carries on business in that other State through a permanent establishment. If a foreign corporation has no permanent establishment in the US within the meaning of Art. 5 OECD Model Convention the right to tax business profits (e.g. reinsurance premiums) is allocated exclusively to the state of residence of the foreign company. Also see Articles 5 and 7 of many US tax treaties and in the 2006 US Model Income Tax Convention.
- Even if a foreign company has a permanent establishment in the US, the second principle reflected in Art. 7, states that the US right to tax does not extend to profits (e.g. reinsurance premiums) that the foreign company may derive from the US but that are not attributable to the permanent establishment. This "force of attraction" approach has been rejected by international tax treaty practice.

Furthermore, the election envisaged in the Proposals inevitably results in double taxation since the US tax paid is not allowed as credit against the tax paid in the state of residence of the foreign company. Art. 23 B OECD Model Convention provides that the relief from double taxation requires taxation in accordance with the provisions of the Convention.

Thus, the election at stake would contravene elementary structures of international taxation and therefore should not be upheld. Otherwise the US would fail to comply with the obligations grounded on the double tax treaty network in force.

3. Substantial taxes paid by European Reinsurers

Cross-border reinsurance, whether with a related or unrelated party, moves the risk of loss to the non-US entity. Profits or losses on premiums associated with this risk are respectively taxed or deducted abroad where the risk now resides and, specifically in the European countries represented by the CEA, the reinsurance premiums paid to reinsurers are subject to local corporate taxation.

While the aim of the Proposals is said to be to eliminate tax advantages for companies not paying US federal income tax, EU reinsurers in fact already pay substantial taxes (the average EU tax burden amounts to approximately 25%). As the average tax level in the EU is comparable to the US average, there is no tax incentive for US affiliates of European (re)insurers to cede risks to Europe.

If any of the Proposals came into force, especially with regard to Europe, the violation of double tax treaties would therefore lead to an unjustifiable double-taxation of reinsurance premiums.

4. Transfer pricing rules in place

The transfer pricing rules of US Internal Revenue Code § 482 already empower the IRS to make adjustments necessary to prevent tax evasion or more clearly reflect income earned by US companies. In addition, the special rules of US Internal Revenue Code § 845 on related-party reinsurance further allow the IRS to make adjustments to fully reflect the income of the US insurance company. In the American Jobs Creation Act of 2004, these related party reinsurance rules were amended to further strengthen the IRS's authority to enforce arm's-length pricing in affiliate reinsurance contracts.

Most countries have enacted extensive transfer pricing documentation requirements. Also under US regulations, the taxpayer is obliged to prepare contemporaneous documentation (which is subject to penalties) in order to prove to the IRS that the business relationships with affiliated parties are in line with the arm's-length standard. Foreign-owned companies annually prepare the necessary studies to support their transfer pricing of affiliate reinsurance, and these are available to IRS agents in tax audits.

Considering the above, the current US law already comprises adequate legal authority and practical means to deal with "income shifting" by a US insurance subsidiary to a foreign affiliate reinsurer. No more specific measure is needed.

5. US G20 and WTO commitments

At a time when the US, along with other G-20 members, has agreed to refrain from protectionism, we believe that the Proposals — which only apply to foreign (re)insurers, not to US reinsurers — would constitute a breach of such commitments. At the same time, the Proposals would violate the US WTO commitments under the General Agreement on Trade in Services (GATS). Indeed, this concern was also raised by the European Union and several individual countries in reaction to a similar proposal that was released for comments by the Senate's Committee on Finance in December 2008.

The CEA remains at your disposal and looks forward to assisting in all the issues mentioned above, as well as in any other questions that arise in the course of discussions.

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[i] OECD Insurance Statistics: Edition 2009

[ii] See "Florida Office of Insurance Regulation Reaches Agreement with Hannover Re to be the First to Qualify as an Eligible Reinsurer Under New Terms", FLOIR Media Release, 24 February 2010

[iii] See The Brattle Group "The Impact on the U.S. Insurance Market of a Tax on Offshore Affiliate Reinsurance: An Economic Analysis", May 2009